TAX·FEATURES

States Get Less in U.S. Grants And Pay Less in Taxes in FY82

Fiscal year 1982 marked the first time since World War II that Federal aid to the states and localities—and the associated taxes paid to support those aids—failed to rise. The cost of Federal grant programs in 1982 was $85.5 billion, down by $7.0 billion or 7.6 percent from 1981, and 3.5 percent below the 1980 level of $88.6 billion. This recent trend—stemming largely from the Omnibus Budget Reconciliation Act of 1981—stands in sharp contrast to the decade of the 1970s, when Federal grants to state and local governments grew at an average annual rate of 15 percent.

Twenty states paid more in tax dollars to support Federal grant programs than was received by their state and local governments in fiscal year 1982, according to Tax Foundation economists.

For the second year in a row, the residents of the Lone Star State paid the highest tax "premium" for grants. Each Federal aid dollar coming to Texas cost the state's residents $1.59. The other top "paying" states were Connecticut ($1.40), Florida ($1.30), Kansas ($1.29), and Colorado ($1.29).

At the other end of the scale, Vermont residents paid 57 cents in Federal tax dollars in support of the grant programs for each dollar of aid received by their state and local governments. Favorable balances were also experienced by Mississippi (57 cents), Maine (60 cents), Alaska (61 cents), South Dakota (62 cents), and New Mexico (69 cents).

As a whole, the residents of the "paying" states remitted $47.7 billion in Federal taxes to support grant programs, while their state and local governments received $39.1 billion in Federal grants—an average of $1.22 per aid dollar. The residents of the "receiving" states, on the other hand, paid $37.8 billion in Federal taxes for the nearly $46.4 billion received in Federal grants, or 81 cents in taxes for each $1.00 of aid received.

Compared to fiscal year 1981, the costs of Federal aid received rose in 22 states, fell in 24 states and the District of Columbia, and remained the same in four states (Arkansas, Iowa, New Mexico, and Wyoming). The largest increase was in Texas, where Federal tax burdens per $1.00 of grants received rose by 13 cents—from $1.46 to $1.59. In Tennessee and North Dakota, Federal tax burdens per dollar of aid received rose by 10 cents—from 82 cents to 92 cents, and from 73 cents to 83 cents, respectively.

The largest decline in tax costs per dollar of aid was "enjoyed" by the residents of New Hampshire—from $1.21 in 1981 (when it ranked 8th) to $1.08 in 1982 (when it ranked 18th). Oregon rejoined the ranks of the "receiving" states as its Federal tax burden per dollar of aid fell from $1.08 in 1981 to 97 cents in 1982 (Maryland's ratio fell from $1.03 to 98 cents). The ratio

(Continued on page 2)

Tax Index Rises in 1982; Marks 24 Consecutive Years Of Increases in Tax Load

Recent Federal tax cuts and the economic recession notwithstanding, the Tax Foundation's overall Tax Index moved upward in calendar year 1982. The Index, which measures trends in Federal, state, and local taxes based on 1967 as 100, reached 413.9 in 1982, edging up a

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Tax Index and Related Measures

Annually, and Quarterly at Seasonally Adjusted Annual Rates, 1967 = 100
Selected Periods, 1970 to 1982

Calendar year and quarter	Tax Index			Output Index[a]		
	Total	Federal	State and local	Current prices	Constant prices	Price Index[b]
Annually						
1970	132.2	127.5	142.1	124.2	107.3	115.7
1975	204.3	191.0	232.1	193.8	122.0	158.8
1976	234.0	220.7	261.7	214.9	128.4	167.4
1977	263.1	249.7	291.1	239.9	135.4	177.1
1978	296.2	287.3	314.8	270.6	142.2	190.3
1979	331.5	328.4	338.0	302.4	146.3	206.7
1980	361.2	358.9	365.8	329.3	145.7	226.0
1981	412.4	416.9	403.2	367.4	148.6	247.3
1982	413.9	406.3	429.8	382.6	146.0	262.0
Quarterly						
1980 I	351.7	349.4	356.4	322.2	147.8	217.9
II	348.7	345.5	355.4	321.8	144.1	223.3
III	363.2	360.1	369.7	330.6	144.7	228.4
IV	381.0	380.6	382.0	342.6	146.3	234.2
1981 I	405.4	411.4	392.8	358.3	149.1	240.3
II	410.3	416.2	398.0	362.9	148.5	244.3
III	419.8	425.0	409.1	372.8	149.3	249.6
IV	414.3	414.9	412.9	375.6	147.3	254.9
1982 I	407.6	404.4	415.1	374.6	145.4	257.6
II	413.8	408.5	424.7	380.8	146.2	260.5
III	415.8	406.1	436.0	386.2	146.4	263.7
IV	418.6	406.7	443.5	388.7	146.1	266.2

[a]Gross national product.
[b]Implicit price deflator for gross national product.
Source: Tax Foundation computations and estimates based on data from U.S. Department of Commerce, Bureau of Economic Analysis.

Federal Grants-In-Aid to State and Local Governments and Estimated Federal Tax Burden for Federal Grants
Fiscal Year 1982

State	Millions		Tax burden per dollar of aid	
	Grants[a]	Estimated tax burden for grants[b]	Amount	Rank
TOTAL	$85,494.2	$85,494.2	$1.00	—
Alabama	1,394.0	1,085.1	.78	37
Alaska	391.7	240.3	.61	47
Arizona	779.5	946.1	1.21	8
Arkansas	816.9	592.0	.72	44
California	8,931.9	10,119.1	1.13	14
Colorado	920.0	1,183.5	1.29	5
Connecticut	1,120.1	1,566.2	1.40	2
Delaware	279.4	244.9	.88	29
Florida	2,855.7	3,705.5	1.30	3
Georgia	2,181.5	1,691.2	.78	38
Hawaii	407.6	371.4	.91	28
Idaho	329.5	275.3	.84	32
Illinois	4,101.6	4,978.0	1.21	9
Indiana	1,557.9	1,915.5	1.23	7
Iowa	892.8	1,052.9	1.18	11
Kansas	704.8	910.6	1.29	4
Kentucky	1,412.5	1,035.9	.73	43
Louisiana	1,588.4	1,475.7	.93	26
Maine	526.7	317.5	.60	48
Maryland	1,820.7	1,785.5	.98	21
Massachusetts	2,745.2	2,283.8	.83	33
Michigan	3,631.8	3,438.8	.95	23
Minnesota	1,767.2	1,539.9	.87	30
Mississippi	1,072.0	606.5	.57	49
Missouri	1,647.9	1,683.1	1.02	20
Montana	349.9	265.5	.76	39
Nebraska	523.1	562.7	1.08	19
Nevada	328.4	364.8	1.11	15
New Hampshire	316.4	342.5	1.08	18
New Jersey	2,718.4	3,418.4	1.26	6
New Mexico	563.4	387.1	.69	45
New York	9,287.5	6,995.2	.75	40
North Carolina	1,849.8	1,738.3	.94	25
North Dakota	285.6	236.8	.83	34
Ohio	3,611.0	3,977.3	1.10	17
Oklahoma	986.1	1,094.8	1.11	16
Oregon	969.9	939.6	.97	22
Pennsylvania	4,626.9	4,356.7	.94	24
Rhode Island	471.0	351.7	.75	41
South Carolina	1,039.4	850.8	.82	36
South Dakota	321.4	199.9	.62	46
Tennessee	1,502.5	1,382.9	.92	27
Texas	3,719.8	5,900.2	1.59	1
Utah	520.0	428.4	.82	35
Vermont	270.4	152.8	.57	50
Virginia	1,644.6	1,995.5	1.21	10
Washington	1,548.8	1,794.4	1.16	12
West Virginia	770.5	568.1	.74	42
Wisconsin	1,893.3	1,618.8	.85	31
Wyoming	190.0	219.9	1.16	13
District of Columbia	1,308.9	307.0	.23	51

[a]Excludes shared revenues and payments in lieu of taxes; includes general revenue sharing and trust fund aids
[b]The total tax burden for grants is assumed to equal grant payments.
Source: Tax Foundation computations based on data from U.S. Treasury Department and Office of Management and Budget.

Monthly Tax Features

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(TAX INDEX, from page 1)

fraction of a percent from its 1981 level of 412.4. According to Tax Foundation economists, 1982 marked the 24th consecutive rise for the annual Tax Index.

While the overall trend was up, the various components underwent a mixture of ups and downs. The Federal Tax Index dropped from 416.9 to 406.3 (2.5 percent), reflecting a sharp decline in accruals of corporate profits taxes (corporate profits dropped by nearly 20 percent) and the crude oil windfall profits tax, and a smaller rise in personal income taxes than would have occurred without the tax cuts of ERTA, the Economic Recovery Tax Act of 1981. Boosts in social insurance taxes were the major component preventing the Federal Index from declining even more.

Unlike its Federal counterpart, the State-Local Tax Index continued its long-time upward movement, rising 6.6 percent from 403.2 in 1981 to 429.8 in 1982 (1967=100). The strongest element in the rise was the local property tax, for which collections in 1982 were nearly 14 percent ($10.5 billion) higher than in 1981. State personal income and sales taxes exhibited modest increases—bolstered in part by legislative tax increases—while corporate profits taxes were off by more than 25 percent, an even larger drop than their performance at the Federal level.

Calendar year 1982 marked the first time since 1975 that the annual Federal Tax Index had declined from the previous year. State-local taxes have not shown an annual reduction since 1933.

The rise in the Tax Index in 1982 failed to match the 4.1 percent increase in the nation's current dollar output or the 6 percent hike in the price index. The standing of the Tax Index relative to its 1967 base, however,

(Continued on page 4)

MARK YOUR CALENDAR

Tax Foundation's 35th National Conference and 46th Annual Dinner will be held this year on Wednesday, November 30, 1983, at the Plaza Hotel in New York City. Details will follow in future issues of *Monthly Tax Features*.

(GRANTS-IN-AID, from page 1)

declined by 10 cents in Missouri and South Carolina.

The direct cost, in terms of Federal tax burdens per dollar of aid received, does not tell the entire story. Most Federal grant programs require matching funds, and the Office of Management and Budget estimates that for each $1.00 of aid from Washington, state and local governments must ante up another 45 cents. And this figure does not include any administrative or overhead costs that the recipient governments must bear.

The Tax Foundation formula for deriving the Federal tax burdens by state is designed to show where the tax dollars actually originate, rather than where they are collected. The grant-in-aid data are shown as reported by the U.S. Treasury.

The accompanying table provides further details. Single copies of the complete "Memorandum on the Allocation of the Federal Tax Burden and Federal Grants-in-Aid by State, Fiscal Year 1982" are available free from the Tax Foundation (plus $1.00 postage and handling).

Tax on Health Premiums Poses Questions

The Reagan Administration proposes in its fiscal year 1984 Budget that employees be required to pay social security and income taxes on employer-paid health insurance premiums above certain amounts. Legislation has been introduced in the Senate (S.640) by Senator Robert Dole (R-Kan.) and in the House (HR.2574) by Representative Barber Conable (R-N.Y.) which would impose a maximum level above which employer contributions would no longer remain tax free.

The most commonly cited justifications set forth for such a ceiling is that the "tax benefit" makes health insurance coverage less expensive than if the employees were given an equivalent amount of cash and told to purchase their own health insurance. Employees would purchase less insurance (higher deductibles, fees for specific service, narrower coverage, etc.), the argument runs, and would also make less use of health care facilities and services. This, it is suggested, will help slow the rapid rise in health care costs.

The link between the level of health insurance coverage of American workers and the increasing cost of health care services raises a number of questions. Can the fixed costs of hospitals, equipment, training of personnel, and research and development of medicines be significantly affected by reducing the insurance coverage of U.S. workers? Does the gain that may accompany reduced coverage and reduced use of health services outweigh the potential loss in preventive care? Does the demand for health care services by the non-covered workers, the unemployed, the retired and elderly, have a stronger impact on health care costs than health-related fringe benefits?

A major source of the demand for health care services, of course, is the Federal government itself. During fiscal year 1982, Uncle Sam spent $74.0 billion on health-related programs, more than 90 percent of which was spent directly on health care services. Current projections estimate that spending will increase to $94.7

(Continued on page 4)

"A major source of the demand for health care services is the Federal government itself."

THE FRONT BURNER

By Robert C. Brown
Executive Vice President
Tax Foundation, Incorporated

"About-Face on Withholding"

Few reversals in Washington have been as rapid as the reversal on implementing the provision to withhold taxes from income earned on interest and dividends. The reversal came despite tremendous support for withholding from the leadership in both Houses of Congress, as well as from the White House.

Why?

One reason, of course, is that the U.S. Congress begins to see the light when it starts to feel the heat. However, to give all the credit to the bankers for generating that heat is simplistic in the extreme.

No interest group in our pluralistic society can hope to wield enough clout to force Congress to reverse on a major issue. To assert otherwise is to impugn the integrity of the highest legislative body we have.

The banks may have publicized the problem, as is their right. But hundreds of thousands of savers and investors told the decision makers in Washington how they felt about the withholding provision.

What stuck in most people's craws stems from a misreading by the lawmakers of two important points:

• First, the withholding debate portrayed the average taxpayer and saver as a scofflaw, a tax cheat. The tax-writers had in mind a revenue grab—an estimated, some would say an overestimated, $17.8 billion. They sought to finesse their greed by branding the ordinary saver and investor as dishonest. It didn't fly.

• Second, opponents of the bill did not get their day in court. The provision originated in the Senate Finance Committee and was rammed through the Committee with virtually no debate and in a one-sided party line vote that flew in the face of a long-standing tradition of bipartisan tax policy on the Committee. Those fighting for their day in court were threatened with even more stringent tax legislation if they opposed and defeated the withholding provision.

Such a cavalier attitude generated deep resentment. In our representative democracy we are used to arguing strongly for a position, taking a vote, and accepting the decision and working to make it succeed. "You win some, and you lose some" is a fundamental axiom of the political process.

The trouble with the withholding legislation, as passed last year, was that most of the nation wasn't even allowed in the ballgame. That proved intolerable to the American public, which has now made its feelings known.

"The trouble with the withholding legislation, as passed last year, was that most of the nation wasn't even allowed in the ballgame."

Tax Foundation, Incorporated

"Social insurance levies have attained by far the highest Index standing relative to the 1967 base."

(TAX INDEX, from page 2)

remains significantly above the output and price indexes, as shown in the table on page 1.

The table also presents the Tax Index and related measures on a quarterly basis since 1980. In the latest quarter reported—October-December, 1982—the Tax Index moved up at an annual rate of 2.8 percent from the previous quarter, as a 7 percent annual rise in the State-Local Index was accompanied by a negligible (.4 percent) increase in the Federal Index.

During the economic downturn that began in July 1981, the Tax Index followed the general cyclical contraction in the fourth quarter 1981 and the first quarter of 1982, but rose slightly in the last three quarters of 1982, again reflecting relative strength in state-local taxes counterbalancing weaknesses in Federal tax accruals. The quarterly reductions in the Tax Index that did take place were all accounted for by Federal taxes. The State-Local Tax Index continued to rise throughout the latest recession, which may have ended last December.

By type of tax, social insurance levies have attained by far the highest Index standing relative to the 1967 base. Personal income taxes came in a distant second. The major components of the Tax Index (Federal and State-Local combined) for the fourth quarter of 1982 (1967=100) were as follows:

Tax	Index
Social insurance	596.4
Personal income	490.2
Indirect business (sales, property, excises)	365.5
Miscellaneous	235.8
Corporate profits	178.9

The Tax Index is a fiscal yardstick designed by Tax Foundation economists to provide a continuing measure of trends in taxes, on a basis comparable to official indexes for other segments of the economy.

Now Available

"Consumption Tax: An Idea Whose Time Is Coming," *Special Report*, April, 28 pp., $5.00.

"The Federal Fiscal Dilemma: Is There a Solution?", *Proceedings* of Tax Foundation's 34th National Tax Conference, 1982, 36 pp., $7.50.

"Unemployment Insurance: Trends and Issues," *Research Publication* No. 35, 96 pp., $5.00.

(Please include $1.00 for postage and handling on all orders.)

Effect of Limiting Exclusions for Employer Contributions to Health Care Plans to $150 Per Month for Family Subscribers and to $60 Per Month for Individual Subscribers

Income level ($000)	Subscribers affected by limit: Family coverage Number (000)	Family coverage Percent of total covered	Individual coverage Number (000)	Individual coverage Percent of total covered	Average increase in total tax[a]
0-10	426	25.5	512	17.3	$ 86
10-15	510	18.6	855	21.5	118
15-20	1,255	27.0	1,051	26.6	135
20-30	3,163	26.8	2,110	26.2	163
30-50	6,098	36.5	3,237	28.6	235
50 +	2,492	34.4	1,769	16.6	245

[a]Excludes subscribers whose tax liability does not change, excludes employers' share of social security tax, and any increased state tax liability.

Source: "Tax Expenditures and the Demand for Private Health Insurance," 1982, U.S. Department of Health and Human Services, and Tax Foundation computations.

(HEALTH INSURANCE, from page 3)

billion by fiscal year 1985. In comparison, the estimate of the total Federal individual income tax revenue forgone by the exclusion of employer contributions from employee income is $16.5 billion for fiscal year 1982.

Limiting the exclusion would increase individual tax bills by $2.4 billion if caps of $175 per month family coverage and $75 per month individual coverage were adopted and by $3.9 billion for caps of $150 per month family coverage, $60 per month individual coverage. Under the latter plan, 34 percent of all subscribers covered by employer-provided health insurance would be affected, with an average tax increase of $198.

The accompanying table sets out the distribution of subscribers by income class affected by a $150/$60 cap and the average increase in tax they would pay.

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FEDERAL TAX POLICY MEMO

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U.S. Tax Treatment of Foreign Source Income

By Douglas N. Beck
Staff Economist

Recently there has been increasing talk of modifying the various provisions contained in the U.S. Tax Code pertaining to the treatment of domestic corporations involved in international trade. Motivated by numerous, often conflicting goals, several proposals have been made that would either curtail or eliminate the foreign tax credit, "deferral," and the law establishing Domestic International Sales Corporations (DISC)—the three provisions that form the basis of U.S. tax policy relating to international trade. The foreign tax credit and deferral, which have been part of the Tax Code since 1918, serve to neutralize tax considerations in worldwide investment decisions. On the other hand, DISC, enacted only twelve years ago, was designed to encourage exports of U.S. products. Although the basic nature of the foreign tax credit and deferral are dissimilar to DISC, they will be considered together for ease of presentation.

The renewed movement to alter these provisions is largely a response to two conditions currently plaguing the American economy. First is the prospect of big budget deficits continuing for many years and the consequent search for new sources of income to narrow this gap. Opponents of the provisions see them as "loopholes" that can be closed to raise large sums of additional revenue.

Second is the claim that current U.S. tax law, in particular the foreign tax credit and deferral, is in part responsible for the high level of unemployment that plagues the American economy. Critics claim that these provisions permit more favorable tax treatment for foreign source income than for income earned domestically and thereby provide an incentive for U.S. businesses to invest in foreign countries rather than in the United States. This "substitution" of foreign for domestic investment causes jobs to be "exported" overseas. Tightening the tax treatment of U.S. firms investing abroad would reduce foreign operations and increase domestic investment, thereby increasing U.S. employment.

Another important consideration is the claim by several European countries that DISC violates the General Agreement on Tariffs and Trade (GATT), ratified in 1947 to establish an international code on tariffs and trade rules. GATT's goal was to reduce impediments to international trade created by high tariffs, import quotas, and other discriminatory trade practices. This agreement is widely believed to have been responsible for the dramatic increase in world trade over the last forty years and the accompanying rise in the standard of living in signatory countries.

U.S. TAX LAW

Tax law in the United States recognizes the importance of the principle of international tax neutrality, also known as capital export neutrality, which holds that the tax laws of a given country should neither favor nor discourage foreign over domestic investment. In practice, neutrality requires that the overall level of taxation on foreign source income of a firm or individual be the same as for domestic source income. Investment decisions can thus be made based on economic variables rather than tax considerations, promoting international specialization in production with a resultant increase in worldwide income. Deviations from tax neutrality can create distortions causing resources to be misallocated and income reduced.

FOREIGN TAX CREDIT

Under U.S. law, American citizens are taxed on their worldwide income. In order to prevent the double taxation of income earned abroad, a dollar-for-dollar credit is allowed for taxes paid by U.S. citizens to foreign governments. This credit mechanism also concedes to the host government the initial share of taxation on income generated within its borders.

To see how the foreign tax credit works, suppose an American firm earns $100,000 within a foreign country that imposes a 20 percent income tax. The U.S. tax liability on this income is $46,000 based on a statutory corporate income tax rate of 46 percent. Against this amount the taxpayer is allowed a credit of $20,000 for taxes paid to the host country. The remaining $26,000 is paid to the U.S. Treasury. If the tax rate imposed by the host country was equal to or greater than 46 percent, the U.S. tax liability on that foreign source income is zero.

U.S. law also allows a credit for foreign taxes paid through foreign corporations, provided that the U.S. corporation owns at least 10 percent of the voting stock of the foreign corporation. This "deem paid" credit provision allows the U.S. corporations to claim a credit for foreign taxes paid on the earnings of a foreign subsidiary out of which dividends are paid to the U.S. corporation. For example, suppose that a domestic corporation receives a dividend of $80 from a foreign corporation. This $80 dividend represents $100 in income earned by the foreign corporation from which $20 in taxes is paid to the host government. For purposes of calculating the U.S. tax liability, the $20 in foreign taxes paid is added to the $80 dividend, making the taxable foreign source income of the domestic corporation equal to $100. This is known as "grossing-up" the dividend. The U.S. tax liability is $46 ($100 x 46%) against which a credit of $20 is granted, and the balance of $26 is collected by the U.S. Treasury.

In actual practice the foreign tax credit becomes somewhat more complicated. In order to be creditable, a foreign tax must be of the predominant character of the U.S. income tax.

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In particular, the foreign tax must not be a payment in return for a specific economic benefit. It must be based on the taxpayer's realized net income, and it must be subject to the reasonable rules of the taxing jurisdiction. These limitations prevent payments to foreign governments for goods and services received, which are really a business expense, from being used to reduce U.S. tax liability; they also prevent foreign governments from enacting so-called "soak-up" taxes, levied by the host governments exclusively on U.S. firms to collect the difference between the tax rates of the foreign country and the United States. By limiting the creditability of taxes to those that the host country imposes on its own domestic firms, this abuse is prevented.

A second source of complexity results from the limitation that U.S. law places on how much credit may be claimed for foreign taxes paid. This limit prevents credits in excess of those necessary to offset U.S. tax liability on foreign income from being used to reduce tax liability on domestic source income. The credit limitation is computed by multiplying the ratio of a company's foreign source taxable income to its worldwide taxable income by its pre-credit tax liability. The amount of tax that may be credited is limited to the amount of tax that would have been imposed had the income been earned domestically. For example, if a U.S. corporation earns $1,000,000 from foreign sources, the credit for foreign taxes paid is limited to $460,000, which would be the U.S. tax liability on this income if earned domestically. If the host government imposes a 60 percent income tax, the company will be able to credit only $460,000 of the $600,000 it would owe the foreign government. The remaining $140,000 would have to be absorbed out of profits.

For foreign tax credits in excess of this limitation, a carryback/carryforward provision is allowed. Credits that cannot be used in the current year may be carried back to the two preceding taxable years or forward to the five succeeding taxable years. While providing for partial recovery of credits that would otherwise be lost, this rule does not totally offset the restrictive effect of the foreign tax credit limitation.

Although credit limitation prevents excess credits for foreign taxes from reducing U.S. tax liability on domestic source income, nevertheless U.S. liability may be reduced when foreign losses exceed foreign income. In these cases the amount of the net operating loss may be deducted from domestic taxable income. In order to limit the benefits of this provision, such losses are subject to recapture. A portion of foreign source income earned in subsequent years is treated as if it were earned from domestic sources. Such treatment is limited to the amount of the loss or 50 percent of the foreign source income for the subsequent year, whichever is less, although the taxpayer may have a larger percentage recharacterized as domestic income if he chooses.

The U.S. Tax Code requires that domestic companies apply the foreign tax credit separately to their foreign oil and gas activities. These companies must first compute a credit limit for all their oil- and gas-related income, and then a separate limit for their extraction income. The amount of foreign tax credits that may be claimed on this income is limited to the lesser of the overall oil-related limit, or extraction income limit plus taxes paid on non-extraction, oil-related income. Prior to the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), extraction losses in one country were not included when calculating overall extraction income. Presently, losses incurred in one country offset income earned in another, limiting the amount of the foreign tax credit that may be claimed. Extraction taxes in excess of this limitation for the current year may be carried back two years or forward five years provided the amount does not exceed 2 percent of the taxpayer's extraction income.

DEFERRAL

Companies incorporated under the laws of the United States are subject to U.S. taxation on their worldwide income, including income earned by foreign branch operations. Yet, in most instances, domestic corporations conduct their foreign operations through a subsidiary corporation rather than a branch operation. Many factors, including the laws of the host country, frequently necessitate this form of organization.

Because a foreign subsidiary is a separate legal entity, its income is not included in the worldwide income of its domestic parent company or subject to taxes under the U.S. law until it is actually received by the parent in the form of a dividend. When dividend income is received, a credit is allowed to the parent for taxes paid by the subsidiary to the host government on earnings out of which the dividend is paid. The amount of the credit is determined using the gross-up method in the same way as the deem paid credit.

The tax significance depends on the difference between the rate imposed by the host country and that imposed by the United States. In cases where the host country imposes a tax rate that is either equal to or greater than the U.S. rate, there will be no U.S. tax liability and the timing advantage associated with deferral will have no effect. This is the case in most industrialized nations. Only in cases where the host country imposes a considerably lower income tax rate than the United States will the impact of deferral be significant. This occurs most often in developing countries that utilize their tax structures as a means of encouraging investment and growth. Such countries will occasionally defer collection of their taxes as a further incentive. If an acceleration of tax payments is imposed, U.S. subsidiaries operating in certain foreign countries could be faced with significantly higher taxes.

DOMESTIC INTERNATIONAL SALES CORPORATION (DISC)

The third major aspect of U.S. law affecting U.S. businesses involved in foreign trade is DISC. This legislation, enacted under Title V of the Revenue Act of 1971, is designed to encourage exports of U.S. products by granting favorable tax treatment for income earned from export sales by the DISC. Basically, the DISC functions by buying domestically produced products and reselling them abroad.

In order for a corporation to qualify as a DISC, at least 95 percent of its gross receipts must come from qualified exports, and 95 percent of its assets must be qualified export assets. An additional requirement is that the corporation must have only one class of stock, and it must maintain capital of at least $2,500 at all times.

If these conditions are met, the corporation is entitled to special tax treatment consisting of deferral of taxation on a portion of its income equal to one-half of the excess over a prescribed base amount. This base amount is defined in the

law to be 67 percent of the average gross export receipts for the four-year period commencing with the seventh year prior to the tax year in question. For example, the base period for the taxable year beginning in 1982 would be 1975 through 1978. The balance of the DISC's income is taxed currently to its shareholders as a deemed distribution even if not actually distributed. To see how this provision works, suppose that a DISC had qualified export receipts of $1,000 in a current tax year and average gross receipts of $500 in its base period. According to the incremental rules, the base amount would be $335 (67% × $500), and the amount of income upon which taxation is deferred would be $332.5 (½ × [$1,000 − $335]). The remaining $667.5 would be taxed concurrently to the shareholders.

Incremental rules added to the original DISC legislation by the Tax Reform Act of 1976 significantly modified the original act. The change was designed to limit DISC benefits to new incremental exports, and thus to make the program more cost effective and more efficient at achieving its original goal of increasing exports. Under the original law, a postponement was granted for taxation on one-half of total DISC income with the other half taxed to the shareholders as a deemed distribution. It was felt that this resulted in an unintended benefit for exports that were based on contracts entered into prior to DISC.

Pricing Under DISC

In practice, the DISC is usually established as a subsidiary of domestic corporations and is frequently only a paper corporation sharing employees and offices with the parent corporation. The only separation legally required between the DISC and its parent is that the DISC maintain its own books and records. This set-up raises the issue of the allocation of income between the parent and the DISC and the related issue of inter-company pricing.

In most circumstances, the pricing of sales between parent and subsidiary corporations is governed by a set of very explicit rules and regulations established by the Treasury Department under the authority granted by Section 482 of the Tax Code. These rules are based on the "arms-length" principle, which requires that prices charged between a parent corporation and its subsidiary be the same as those charged between unrelated parties. This rule is meant to insure that inter-company prices reflect economic realities and are not used as a means of shifting income between related parties to avoid taxes.

These rules and regulations do not apply to prices charged between a DISC and its parent. Under the law a DISC is permitted to charge a price that allows it to realize a taxable income which does not exceed the greater of the following:

(1) 4 percent of the qualified export receipts derived from the resale of the property of the DISC, plus 10 percent of the "export promotion expenses" of the DISC allocable to these receipts (known as the four-percent method);

(2) 50 percent of the combined taxable income derived by both the seller and the DISC from the sale and resale of the property that is attributable to the qualified export receipts, plus 10 percent of the export promotion expenses of the DISC allocable to these receipts (known as the 50-50 method); and

(3) the actual taxable income computed under Section 482 (the "arms-length" method).

CONCLUSION

FTC and Deferral

Opponents of the foreign tax credit and deferral claim that these provisions constitute an unfair incentive for domestic firms to move their operations abroad, resulting in jobs being exported. These critics advocate replacing the foreign tax credit with a deduction, claiming that taxes paid to a foreign government are of the same nature as any other business expense and, therefore, should be deducted from taxable income rather than credited against taxes due. Furthermore, they claim that this would bring the treatment of foreign taxes into line with state taxes, which are deductible rather than creditable.

Critics of the deferral provision claim that it, like the foreign tax credit, provides an incentive for domestic companies to move their operations abroad. They argue that, since the deferral provision allows a domestic corporation to postpone the payment of taxes on income until that income is actually received by the parent, the domestic corporation pays a lower effective tax rate on foreign source income than on domestic source income. Furthermore, in the case where retained earnings are never repatriated, taxes may never be collected.

Proponents of this view advocate the acceleration of taxation on foreign source income. This would be accomplished in one of two ways: limiting the amount of income on which taxation could be deferred, by treating a certain percentage of this income as a deemed distribution to the domestic parent even if no distribution actually takes place; or limiting the length of time for which taxation could be deferred.

The purpose of the foreign tax credit is to prevent international double taxation of foreign source income, and to allow investment decisions to be made independently of tax considerations. The effect of replacing the foreign tax credit with a deduction would be to increase the level of taxation on foreign source income, reducing the ability of U.S. firms to compete in foreign markets. To see the effect of this change, suppose that a U.S. corporation had $100,000 of foreign source income on which it paid $40,000 in taxes to the host government. With the credit, the company would pay $6,000 in taxes to the U.S. government, yielding a total tax liability of $46,000, or 46 percent. If the credit were replaced with a deduction, the tax liability of the company would increase dramatically. The $40,000 of taxes paid to the foreign government would be deducted from the gross income of the company, making its taxable income equal to $60,000. The U.S. tax liability on this amount would be $27,600 (46% × $60,000), making the overall tax liability on the $100,000 of foreign source income equal to $67,600 or 67.6 percent. This increased level of taxes could severely limit foreign investment by U.S. firms.

The belief that this change would increase domestic investment and employment, which gives the proposals such popular appeal, is based on questionable premises. First is the notion that U.S. firms establish operations abroad solely for the purpose of tax avoidance. The FTC does not result in a lower overall level of taxation on foreign source income. Rather, it insures that competing tax claims do not result in double taxation of this income. Of far more importance than tax considerations in decisions to invest abroad is the need

to be able to remain competitive in international markets. The second erroneous belief is that foreign investment substitutes for domestic investment. This view results from the tendency to view overall investment as being fixed in amount and, therefore, to regard investments made abroad as substitutes for investments that would be made domestically. In the real world, the amount of investment is determined by the availability of profitable investment opportunities. Consequently, there is no logical reason to believe that any foreign investment that might be discouraged by increasing the taxation of foreign source income would automatically be translated into domestic investment.

Another flaw in proposals to change foreign source income taxation is that many of them overstate the amount of revenue that would result from such changes. Revenue projections are typically based on the assumption that U.S. corporations with foreign operations would not modify their behavior in the wake of a change in their tax treatment. Such a response would seem very unlikely. If deferral were to be eliminated, foreign subsidiaries would be more likely to accelerate distribution of their earnings in order to minimize their overall tax burden by crediting foreign withholding taxes imposed by host governments on dividends paid outside their country against current U.S. tax liability. The effect would be much lower revenue gains for the U.S. Treasury than projected.

A related concern is the reaction of foreign governments to these changes in the U.S. Tax Code. Such changes are unlikely to be popular with other governments because they impose the U.S. tax structure on other countries, violating their sovereignty to determine the effective tax policy within their borders. It seems quite likely that foreign governments would respond by imposing new taxes or engaging in other discriminatory practices against U.S. firms.

Such proposals would also place a much greater tax burden on foreign source income and make it much more difficult for U.S. firms to conduct business abroad and to compete in international markets. Ultimately, the only beneficiaries of these proposed changes would be foreign corporations which would be able to claim the share of the world's markets previously held by U.S. firms. The issue has been incorrectly presented to the public as being over whether U.S. firms will invest domestically or abroad. The real issue is whether the United States is going to share in the benefits of increased international trade. If U.S. corporations are not allowed to take advantage of profitable investment opportunities in foreign countries, corporations from other countries will, and the U.S. economy will be denied the benefits of those investments. In the long run, such policies could seriously jeopardize the health of the American economy.

The overriding attention that has been given to the effect of foreign investment on domestic employment has obscured the numerous benefits of foreign investment, one of which is the inflow of revenues received by U.S. firms as returns on these investments. These revenues increase the supply of funds available for domestic investment and thereby supplement domestic investment rather than substitute for it.

DISC -Current Proposals for Revision

The critics of DISC are primarily foreign governments claiming that the provision is in violation of GATT. Recent proposals aimed at making the DISC provision conform with GATT requirements while maintaining its export incentive and remaining revenue neutral fall into two categories.

The first, as proposed by Rep. Guy Vander Jagt (R-Mich.), would place an interest charge of 4 percent on DISC deferred income for small exporters (those with less than $250,000 of DISC taxable income) and an interest charge equal to the Federal funds rate for large exporters. The incremental rules would be replaced by a rule allowing for deferral of 100 percent of DISC taxable income up to $250,000 and for 45 percent of DISC taxable income in excess of this amount. All DISC income existing for taxable years prior to December 31, 1983, would be deferred permanently.

The second type of proposal involves establishing foreign corporations through which export sales would be made. One plan, introduced by Rep. Bill Frenzel (R-Minn.), calls for the establishment of an International Sales and Service Corporation (ISSC). The requirements to qualify and the pricing rules applicable would be basically the same as under the present DISC legislation. For tax purposes, the ISSC would be deemed to distribute 60 percent of its taxable income, which would be taxed to the shareholder as a dividend. The remaining 40 percent would be considered tax-free provided that it is invested for one year in qualified trading assets before it is distributed as a dividend.

Another proposal, introduced by Sen. David Boren (D-Okla.), calls for the establishment of an Export Sales Corporation (ESC) in a foreign country through which export sales would be made. The tax treatment of such a corporation would consist of a 100 percent deemed distribution of income. The shareholders would be granted a 26 percent dividend received deduction. The effect of this would be to reduce taxation on export income by 26 percent.

The Reagan Administration has also proposed replacing DISC with a foreign corporation through which export sales would be made. This proposal would permit the foreign corporation to use inter-company prices that generate taxable income that is equal to the greater of:

(1) 17 percent of the combined taxable income earned by the foreign corporation and its related U.S. manufacturer; or

(2) 1.35 percent of the foreign corporation's gross sales, up to 34 percent of the combined taxable income; or

(3) the income it would earn using the arm's-length rules prescribed under Section 482.

Continued pressure from foreign governments makes the enactment of one of these proposals very probable.

Perhaps the most important consideration when discussing international trade and U.S. participation therein is its implications for international economic growth and development. Stability in international affairs is inseparably related to increased international trade. Freer international trade promotes global peace and stability through increasing worldwide output and by fostering international cooperation.

The continued health and prosperity of the U.S. economy, as well as that of the worldwide economy, are linked to continued U.S. participation in international trade. This, in turn, depends on tax policy at least as favorable as the present provisions of U.S. tax law.